Geoffrey Davey, Chief Financial/ Operations Officer, County of Sacramento

Case Study Detailing the Impacts of the Pension Benefit Enhancement Debacle & the Use of POBs to Mitigate Budget Impacts

CDIAC Workshop
September 12, 2004

Background Events Leading to the Pension Funding Debacle

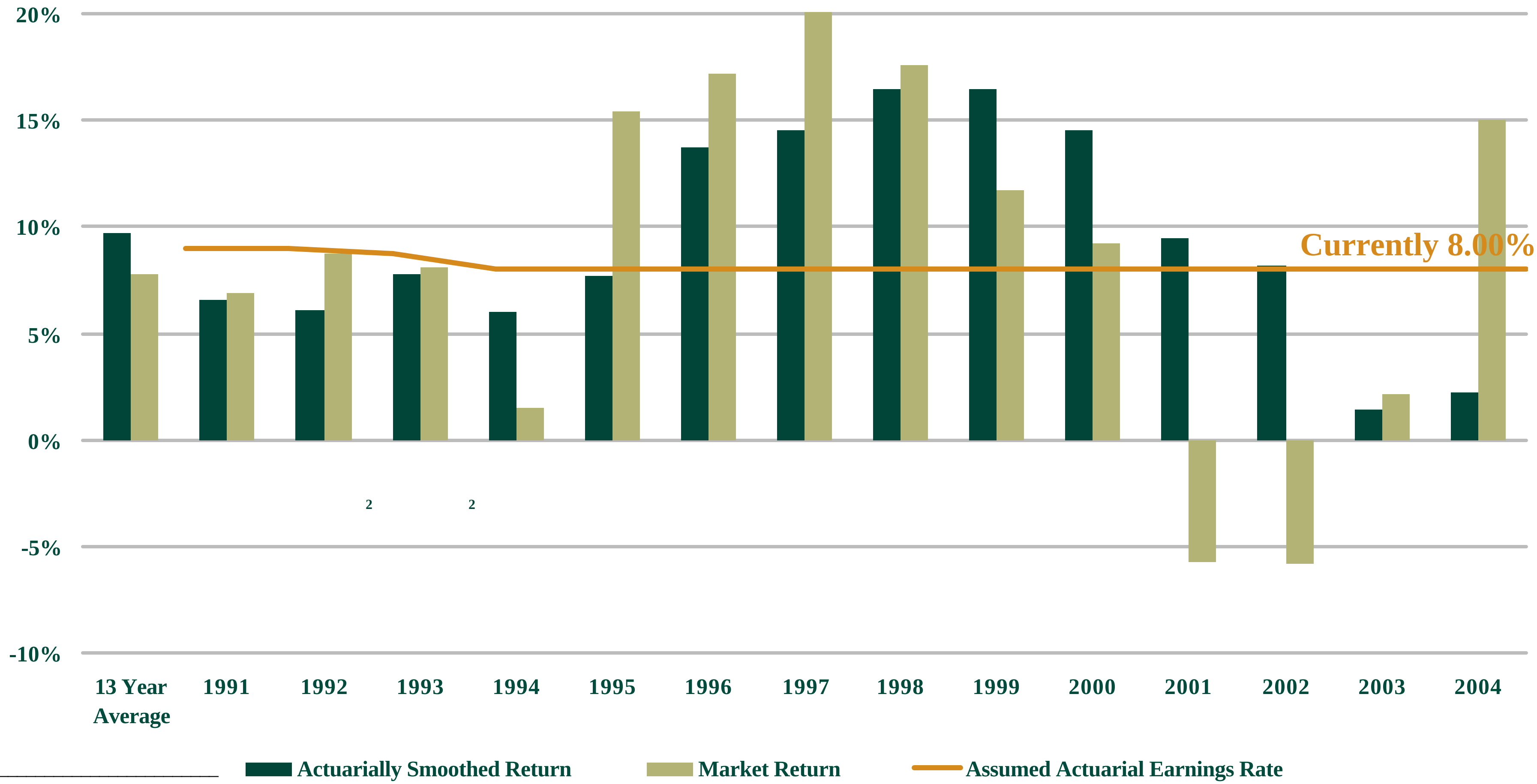
- Stock Market Run-up of 1996-2000; PERS and other pension systems enjoy gains of up to 20%+ annually for 4 years vs. long-term investment return assumptions of 8-8.25%
- PERS and other pension systems develop temporary “excess earnings” of up to 30-35% of portfolio value
- PERS actuaries allow “contribution holidays” by many local governments who contract with PERS for pension benefits, and suggest that holidays will go on for many years
- Previous successful lawsuit by PERS challenging taxpayer benefits from “excess earnings” chill any suggestion that bloated portfolio values should reduce State contributions to PERS

Background Events Leading to the Pension Funding Debacle

- PERS labor-interest dominated Board of Directors advocates for 1999 Legislation (SB 400-Ortiz) to allow enhancement of State employee retirement benefits and local government law enforcement employees
- Subsequent legislation permits enhancements of other local government employee pension benefits to follow suit
- Benefit enhancements costs estimates range from 8-18% of salary but are temporarily masked by "excess earnings"
- Subsequent stock market 2001-2003 correction erases virtually all excess earnings
- 2004 earnings return to meet/exceed actuarial assumption, but nowhere near enough to offset losses during 2001-2003

Retirement System Performance vs. Actuarial Assumptions

Actuarial & Actual Market Rate Investment Returns[1]



1. Net of Expenses

2. Reserves credited with 9.0% interest from unreserved account. For year ending June 30, 1992, reserves were credited with 4.5% interest for the first 6 months, and 4.0% for the second 6 months.

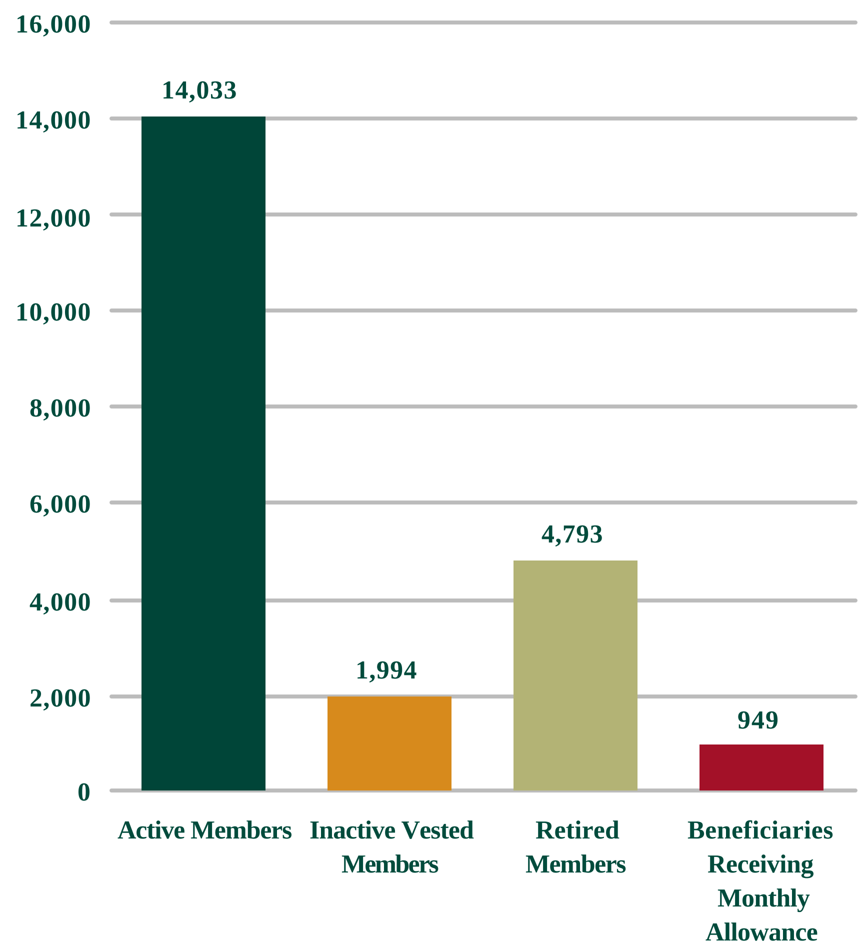
Source: Mercer Human Resources Consulting, Sacramento County Employees Retirements System, Actuarial Valuation Report

Situation Overview: Sacramento County Employees' Retirement System ("SCERS")

As of 6/30/03, System had become underfunded

- System funding status:
  - Overfunded as of 6/30/02 (before enhancements)
  - SCERS uses 5 year smoothing methodology; 20% of gains / losses recognized each year
  - Gains/Losses amortized over a closed 30 year period recommenced as of 2003-04
- Normal retirement age is 50 for Safety and Miscellaneous members with 10 years of service
  - Miscellaneous members may retire after 30 years of service regardless of age
  - Safety members may retire after 20 years of service regardless of age
- Board approved 2% at 55 ½ for Miscellaneous members and 3% at 50 for Safety members effective June 29, 2003
- Previous benefits: 2% at 61 for Miscellaneous members and 2% at 50 for Safety Members
- Benefit increases: 16-25% for Miscellaneous; 50% for Safety

Retirement System Composition



Source: Sacramento County, Retirement System, Annual Actuarial Valuation, June 30, 2002

Impact of Benefit Enhancements

Adoption of 2% at 55 ½ (Miscellaneous) and 3% at 50 (Safety) increased System Liability by $429.6 million

General Employees*

	Annual County Cost[1]
Current Plan[3]	5.38% $28,052
Improved Plan: Total Cost	14.04% $73,197
Improved Plan: Increased in Cost[(4)(5)]	8.66% $45,145
Change in Funding Ratio and Liability	-7.20% / $276,292

Public Safety*

	Annual County Cost[2]
Current Plan[3]	15.42% $23,396
Improved Plan: Total Cost	29.15% $44,224
Improved Plan: Increased in Cost[(4)(5)]	13.73% $20,828
Change in Funding Ratio and Liability	-3.99% / $153,354

$429.6 million

* *Percentages refer to percentage of payroll; figures in $000*

1. *Assumes June 30, 2002 annual County payroll of $521,413 MM.*
2. *Assumes June 30, 2002 annual County payroll of $151,727 MM.*
3. *Reflects recommended rate adopted by the Board for June 30, 2002 valuation.*
4. *Includes all reciprocal terminated vested members.*
5. *Assumes 7/1/03 effective date for benefit improvement.*

Retirement System Assets: 10 Year Perspective

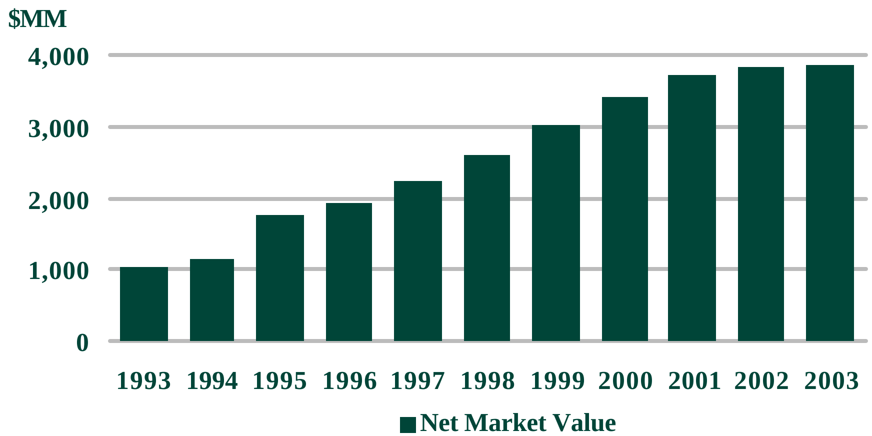
Funding Progress Indicators

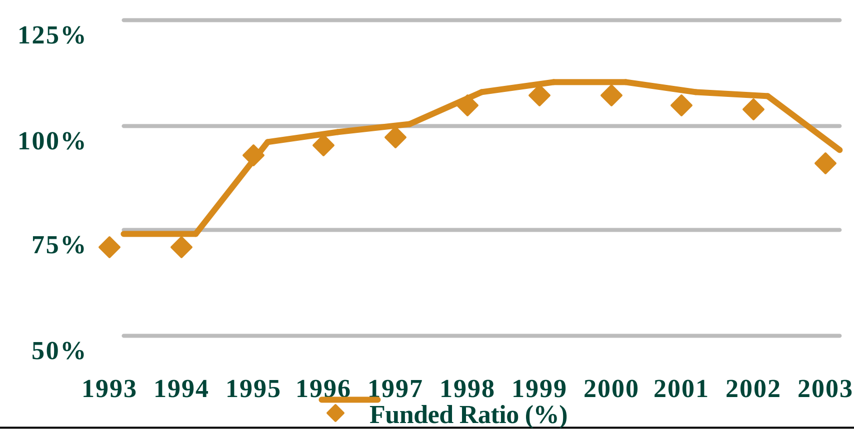
Valuation Date	Actuarial Value of Assets ($000)	Actuarial Accrued Liability ($000)	UAAL ($000)	Funded Ratio (%)
06/30/94	1,141,166	1,541,541	400,375	74.03 [1]
06/30/95	1,767,064	1,835,864	68,800	96.25 [2]
06/30/96	1,956,715	1,987,230	30,515	98.46
06/30/97	2,238,557	2,226,440	(12,117)	100.54
06/30/98	2,600,547	2,409,642	(190,905)	107.92
06/30/99	3,017,639	2,734,548	(283,091)	110.35
06/30/00	3,427,348	3,111,760	(315,588)	110.14
06/30/01	3,718,198	3,451,864	(266,334)	107.72
06/30/02	3,839,081	3,586,250	(252,831)	107.05
06/30/03	3,864,400	4,108,294	243,894	94.06

SCERS' Actuary Estimates County's UAAL at 6/30/04 to be $480 million

1. *Declines in percentages primarily due to changes in salary and interest assumptions in 1992, assumed investment rate was 9.0% and projected salary increase assumption was 6.0%. In 1994, assumed investment rate of return was 8.0% and projected salary increase was 5.5%.*
2. *Includes effect of 1995 POB.*

Net Market Value of Assets vs. Funded Ratio





Understanding the Impact of Unrecognized Market Losses

- SCERS uses a 5 year smoothing methodology, meaning that gains/losses are amortized equally over 5 years

Actuarial Value of Assets Deferred Market Returns

Fiscal Year	Market Value of Assets	Total Market Return	Expected Net Market Return	Investment Gain (Loss)	Deferred Factor	Deferred Return as of 6/30/03
1998-99	3,395,406,934	357,385,286	245,354,021	**112,031,265**	-	22,406,253
1999-00	3,679,912,856	312,187,721	272,141,586	**40,046,135**	0.20	16,018,454
2000-01	3,432,825,810	(211,411,270)	294,518,234	**(505,929,504)**	0.40	(303,557,703)
2001-02	3,199,234,414	(199,589,416)	274,979,342	**(474,568,758)**	0.60	(379,655,006)
2002-03[1]	3,199,234,414	-	255,938,753	**(255,938,753)**	0.80	(255,938,753)
Total				**(1,084,359,615)**		**(900,726,755)**

1. *Estimated*

Understanding the Impact of Unrecognized Market Losses

- SCERS uses a 5 year smoothing methodology, meaning that gains/losses are amortized equally over 5 years
- Example:
  - FY 1999 gain of $112,031,265 realized 20% annually over five years = $22,406,253 per year
  - FY 2003 is the 5th and final year for realizing FY 1999 results. Therefore, there is no remaining deferral, and the deferral factor = 0

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Fiscal Year	Market Value of Assets	Total Market Return	Expected Net Market Return	Investment Gain (Loss)	Deferred Factor	Deferred Return as of 6/30/03
1998-99	3,395,406,934	357,385,286	245,354,0[illegible]	**112,031,265**	-	22,406,253
1999-00	3,679,912,856	312,187,721	272,1[illegible]6	**40,046,135**	0.20	16,018,454
2000-01	3,432,825,810	(211,411,270)	[illegible]8,234	**(505,929,504)**	0.40	(303,557,703)
2001-02	3,199,234,414	(199,589,416)	[illegible]4,979,342	**(474,568,758)**	0.60	(379,655,006)
2002-03[1]	3,199,234,414	-	255,938,753	**(255,938,753)**	0.80	(255,938,753)
Total				**(1,084,359,615)**		**(900,726,755)**

Fiscal Year	FY 1999 Gains/(Losses)
1998-99	22,406,253
1999-00	22,406,253
2000-01	22,406,253
2001-02	22,406,253
2002-03	22,406,253
2003-04	-
2004-05	-
2005-06	-
2007-08	-
Total	**112,031,265**

5 Year Amortization of Gain

1. *Estimated*

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1998-99	3,395,406,934	357,385,286	245,354,021	**112,031,265**	-	22,406,253
1999-00	3,679,912,856	312,187,721	272,141,58[illegible]	**40,046,135**	0.20	16,018,454
2000-01	3,432,825,810	(211,411,270)	294,518,[illegible]4	**(505,929,504)**	0.40	(303,557,703)
2001-02	3,199,234,414	(199,589,416)	274,97[illegible]42	**(474,568,758)**	0.60	(379,655,006)
2002-03[1]	3,199,234,414	-	255[illegible],753	**(255,938,753)**	0.80	(255,938,753)
Total				**(1,084,359,615)**		**(900,726,755)**

Fiscal Year	FY 1999 Gains/(Losses)	FY 2000 Gains/(Losses)
1998-99	22,406,253	
1999-00	22,406,253	8,009,227
2000-01	22,406,253	8,009,227
2001-02	22,406,253	8,009,227
2002-03	22,406,253	8,009,227
2003-04	-	8,009,227
2004-05	-	-
2005-06	-	-
2007-08	-	-
Total	**112,031,265**	**40,046,135**

1. *Estimated*

Understanding the Impact of Unrecognized Market Losses

- SCERS uses a 5 year smoothing methodology, meaning that gains/losses are amortized equally over 5 years
- Example:
  - FY 1999 gain of $112,031,265 realized 20% annually over five years = $22,406,253 per year
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2001-02	3,199,234,414	(199,589,416)	274,979,342	**(474,568,758)**	0.60	(379,655,006)
2002-03[1]	3,199,234,414	-	255,938,753	**(255,938,753)**	0.80	(255,938,753)
Total				**(1,084,359,615)**		**(900,726,755)**

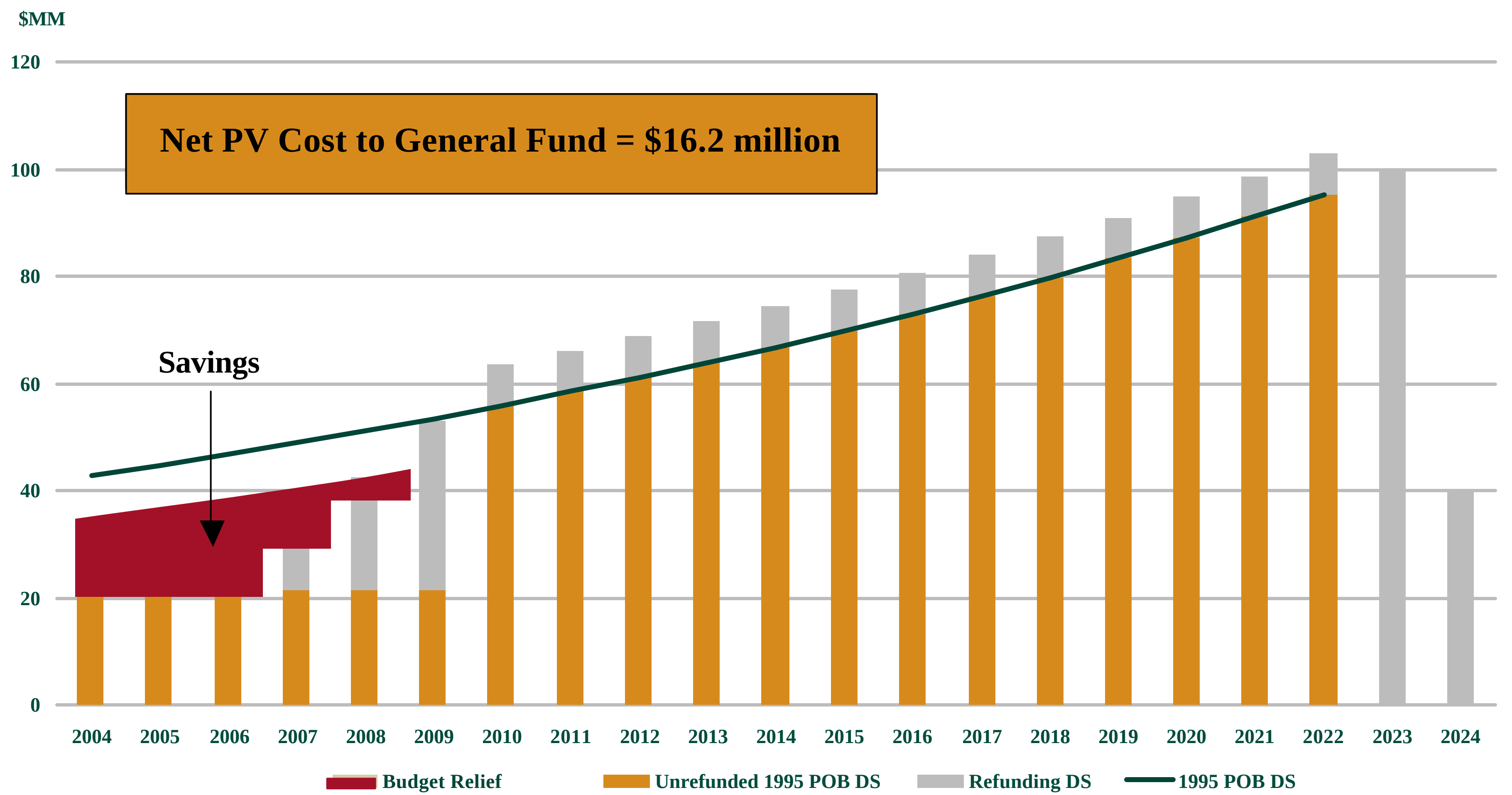
Fiscal Year	FY 1999 Gains/(Losses)	FY 2000 Gains/(Losses)	FY 2001 Gains/(Losses)	FY 2002 Gains/(Losses)	FY 2003 Gains/(Losses)[1]	Total
1998-99	22,406,253					22,406,253
1999-00	22,406,253	8,009,227				30,415,480
2000-01	22,406,253	8,009,227	(101,185,901)			(70,770,421)
2001-02	22,406,253	8,009,227	(101,185,901)	(94,913,752)		(165,684,172)
2002-03	22,406,253	8,009,227	(101,185,901)	(94,913,752)	(51,187,751)	(216,871,923)
2003-04	-	8,009,227	(101,185,901)	(94,913,752)	(51,187,751)	(239,278,176)
2004-05	-	-	(101,185,901)	(94,913,752)	(51,187,751)	(247,287,403)
2005-06	-	-	-	(94,913,752)	(51,187,751)	(146,101,502)
2007-08	-	-	-	-	(51,187,751)	(51,187,751)
Total	**112,031,265**	**40,046,135**	**(505,929,504)**	**(474,568,758)**	**(255,938,753)**	**(1,084,359,615)**

1. *Estimated*

2003 Restructuring of POBs Produced 5 Years of Savings

Transaction provides $47 million of savings to County's General Fund over FY04-08
County anticipates seeking administrative relief from Federal Reimbursements

Funding Vehicle is $97.4MM Convertible CABs Maturing in FY2023 & 54.9MM CABs Maturing 2006-08



Federal Reimbursement Concerns

- Generally, the Fed has concurred that municipalities can “charge back” pension costs to the Federal government for employees in federally grant-funded programs

- As long as debt service on the POBs is lower than UAAL amortization payments, interest on POBs will be Federally reimbursed
  - If refunding bonds are issued, aggregate debt service of refunding POBs must be less than existing POBs in order to be eligible for Federal reimbursement

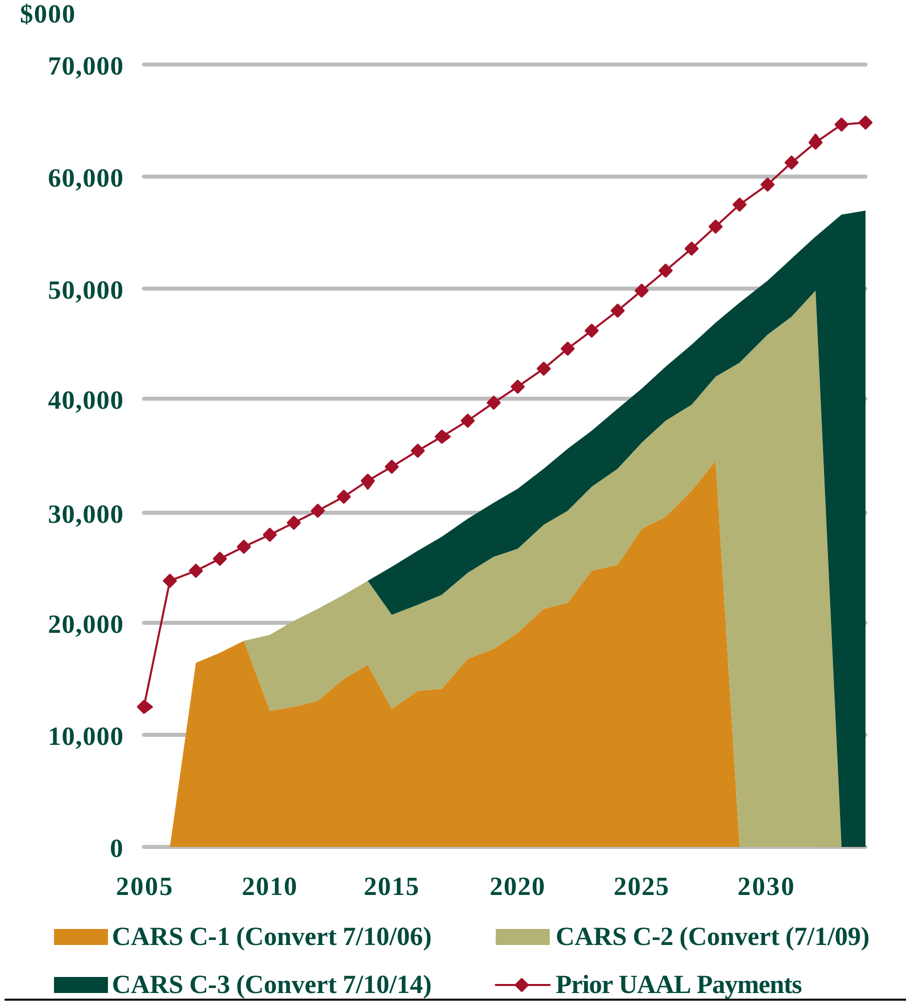
- In the case of Sacramento, the Fed has stated its intention to use the County’s 1995 POB debt service as the new “benchmark” from which to calculate federal reimbursements

- County is challenging Federal opinion since the initial OMB Guidance Letter decision stated that only interest costs less than the UAAL amortization will be federally reimbursed

2004 County of Sacramento POBs Issued July 1, 2004

Convertible Auction Rate Securities (“CARS^{SM}”) provide upfront relief and lower cost variable rate debt

Pro-Forma Debt Service vs. UAAL Payments



Situation Overview

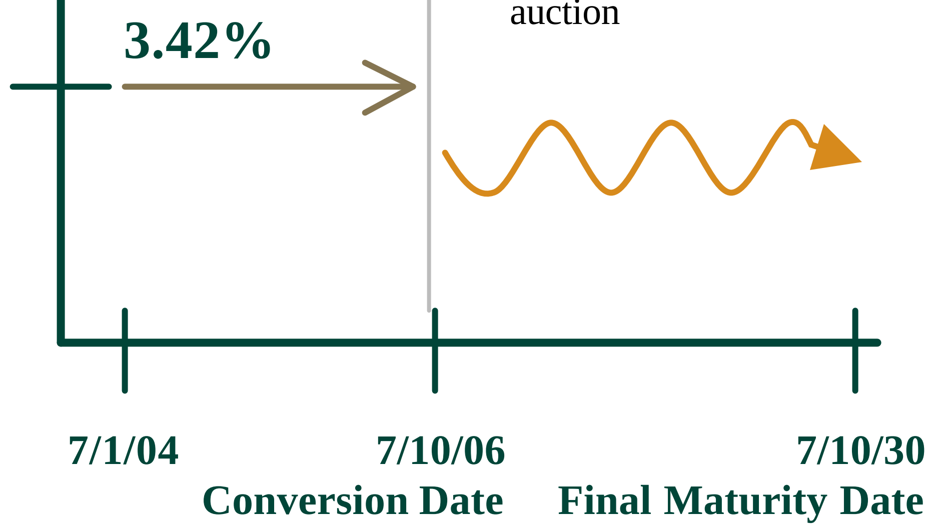
- County has $420 million UAAL and faced significant budget pressure as a direct result of State’s budget situation
- County’s Goals:
  - Near term budget relief, while capturing savings from reducing 8.25% annual interest cost on UAAL
  - Maintain debt repayment flexibility without paying for an expensive call option
- Solution:
  - 3 tranches of CARS^{SM} with different conversion dates
    - Series C-1 Conversion on 7/10/06 with an Initial Accretion Rate of 3.42%
    - Series C-2 Conversion on 7/10/09 with an Initial Accretion Rate of 4.61%
    - Series C-3 Conversion on 7/10/14 with an Initial Accretion Rate of 5.63%
  - Provides required upfront savings and meaningful savings thereafter

The Mechanics of Convertible Auction Rate Securities (CARS^{SM})[1]

- Conventional Auction Rate Securities with initial period in a zero-coupon mode
  - No debt service until conversion date
- The CARS^{SM} are non-callable during the initial accretion period, but have a par call beginning on the conversion date
  - Any business day following each auction thereafter
- At each conversion date, Lehman Brothers and Bear Stearns as the sole broker dealers (Lehman Brothers for Series C-1 & C-2 Bear Stearns for Series C-3), will conduct auctions for the CARS^{SM}
  - In the event of a failed auction the CARS^{SM} would bear interest at the maximum rate

- CARS bear no interest in the initial period, but instead accrete at a fixed rate until the conversion date

- Thereafter, CARS function as conventional auction rate securities
  - County can opt for any periodicity; 7-day, 35-day, or multi-annual
- Callable after any auction



1. *CARS is a service mark of Lehman Brothers*

Sacramento County CARS℠ Pricing Details

Series C-1 CARS℠	
Initial Par Amount	324,582,426.50
Conversion Date	7/10/2006
Accretion Rate	3.4225%
Benchmark Pricing	8/15/06 STRIP + 65bp
Initial Par Amount per $25,000 at Conversion	23,339.50
Par Amount at Conversion	347,675,000.00
Ratings (Underlying)	A2/AA-
Ratings (Insured)	Aaa/AAA/AAA

Series C-2 CARS℠	
Initial Par Amount	39,147,165.75
Conversion Date	7/10/2009
Accretion Rate	4.6110%
Benchmark Pricing	8/15/09 STRIP + 62bp
Initial Par Amount per $25,000 at Conversion	19,881.75
Par Amount at Conversion	49,225,000.00
Ratings (Underlying)	A2/AA-
Ratings (Insured)	Aaa/AAA/AAA

Series C-3 CARS℠	
Initial Par Amount	62,401,528.00
Conversion Date	7/10/2014
Accretion Rate	5.6275%
Benchmark Pricing	8/15/14 STRIP + 62bp
Initial Par Amount per $25,000 at Conversion	14,332.00
Par Amount at Conversion	108,850,000.00
Ratings (Underlying)	A2/AA-
Ratings (Insured)	Aaa/AAA/AAA

Series C-1

FY Ended	Principal	Interest (1)	Compounded Interest	Debt Service (1)
6/30/2005	-	-	-	-
6/30/2006	-	-	-	-
6/30/2007	-	15,379,789.90	-	15,379,789.90
6/30/2008	816,882.50	15,342,742.15	58,117.50	16,217,742.15
6/30/2009	373,432.00	16,857,295.01	26,568.00	17,257,295.01
6/30/2010	700,185.00	15,291,254.51	49,815.00	16,041,254.51
6/30/2011	1,820,481.00	15,210,359.32	129,519.00	17,160,359.32
6/30/2012	1,353,691.00	16,661,303.72	96,309.00	18,111,303.72
6/30/2013	4,294,468.00	14,949,113.46	305,532.00	19,549,113.46
6/30/2014	4,294,468.00	16,227,631.87	305,532.00	20,827,631.87
6/30/2015	2,030,536.50	14,641,296.53	144,463.50	16,816,296.53
6/30/2016	2,240,592.00	15,993,208.93	159,408.00	18,393,208.93
6/30/2017	4,457,844.50	14,327,074.79	317,155.50	19,102,074.79
6/30/2018	6,768,455.00	14,024,174.34	481,545.00	21,274,174.34
6/30/2019	7,001,850.00	15,074,181.57	498,150.00	22,574,181.57
6/30/2020	9,942,627.00	13,226,590.86	707,373.00	23,876,590.86
6/30/2021	11,226,299.50	13,989,335.20	798,700.50	26,014,335.20
6/30/2022	13,980,360.50	12,037,217.70	994,639.50	27,012,217.70
6/30/2023	15,894,199.50	12,446,111.13	1,130,800.50	29,471,111.13
6/30/2024	18,858,316.00	10,390,310.48	1,341,684.00	30,590,310.48
6/30/2025	21,285,624.00	10,367,032.84	1,514,376.00	33,167,032.84
6/30/2026	24,903,246.50	8,199,700.34	1,771,753.50	34,874,700.34
6/30/2027	27,680,647.00	6,948,071.16	1,969,353.00	36,598,071.16
6/30/2028	30,598,084.50	6,110,697.42	2,176,915.50	38,885,697.42
6/30/2029	34,379,083.50	3,873,291.79	2,445,916.50	40,698,291.79
6/30/2030	38,160,082.50	2,350,122.36	2,714,917.50	43,225,122.36
6/30/2031	41,520,970.50	89,938.33	2,954,029.50	44,564,938.33
6/30/2032				
6/30/2033				
6/30/2034				
Total	**324,582,426.50**	**300,007,845.71**	**23,092,573.50**	**647,682,845.71**

Series C-2

FY Ended	Principal	Interest (1)	Compounded Interest	Debt Service (1)
6/30/2005	-	-	-	-
6/30/2006	-	-	-	-
6/30/2007	-	-	-	-
6/30/2008	-	-	-	-
6/30/2009	-	-	-	-
6/30/2010	-	2,177,522.60	-	2,177,522.60
6/30/2011	-	2,177,522.60	-	2,177,522.60
6/30/2012	-	2,395,274.86	-	2,395,274.86
6/30/2013	-	2,177,522.60	-	2,177,522.60
6/30/2014	-	2,177,522.60	-	2,177,522.60
6/30/2015	-	2,395,274.86	-	2,395,274.86
6/30/2016	-	2,177,522.60	-	2,177,522.60
6/30/2017	-	2,395,274.86	-	2,395,274.86
6/30/2018	-	2,177,522.60	-	2,177,522.60
6/30/2019	-	2,395,274.86	-	2,395,274.86
6/30/2020	-	2,177,522.60	-	2,177,522.60
6/30/2021	-	2,177,522.60	-	2,177,522.60
6/30/2022	-	2,395,274.86	-	2,395,274.86
6/30/2023	-	2,177,522.60	-	2,177,522.60
6/30/2024	-	2,395,274.86	-	2,395,274.86
6/30/2025	-	2,177,522.60	-	2,177,522.60
6/30/2026	-	2,395,274.86	-	2,395,274.86
6/30/2027	-	2,177,522.60	-	2,177,522.60
6/30/2028	-	2,395,274.86	-	2,395,274.86
6/30/2029	-	2,177,522.60	-	2,177,522.60
6/30/2030	-	2,177,522.60	-	2,177,522.60
6/30/2031	-	2,395,274.86	-	2,395,274.86
6/30/2032	39,147,165.75	124,429.86	10,077,834.25	49,349,429.86
6/30/2033				
6/30/2034				
Total	**39,147,165.75**	**49,989,697.40**	**10,077,834.25**	**99,214,697.40**

Series C-3

FY Ended	Principal	Interest (1)	Compounded Interest	Debt Service (1)
6/30/2005	-	-	-	-
6/30/2006	-	-	-	-
6/30/2007	-	-	-	-
6/30/2008	-	-	-	-
6/30/2009	-	-	-	-
6/30/2010	-	-	-	-
6/30/2011	-	-	-	-
6/30/2012	-	-	-	-
6/30/2013	-	-	-	-
6/30/2014	-	-	-	-
6/30/2015	-	4,815,100.70	-	4,815,100.70
6/30/2016	-	4,815,100.70	-	4,815,100.70
6/30/2017	-	5,296,610.77	-	5,296,610.77
6/30/2018	-	4,815,100.70	-	4,815,100.70
6/30/2019	-	4,815,100.70	-	4,815,100.70
6/30/2020	-	5,296,610.77	-	5,296,610.77
6/30/2021	-	4,815,100.70	-	4,815,100.70
6/30/2022	-	5,296,610.77	-	5,296,610.77
6/30/2023	-	4,815,100.70	-	4,815,100.70
6/30/2024	-	5,296,610.77	-	5,296,610.77
6/30/2025	-	4,815,100.70	-	4,815,100.70
6/30/2026	-	4,815,100.70	-	4,815,100.70
6/30/2027	-	5,296,610.77	-	5,296,610.77
6/30/2028	-	4,815,100.70	-	4,815,100.70
6/30/2029	-	5,296,610.77	-	5,296,610.77
6/30/2030	-	4,815,100.70	-	4,815,100.70
6/30/2031	-	5,296,610.77	-	5,296,610.77
6/30/2032	-	4,815,100.70	-	4,815,100.70
6/30/2033	30,269,184.00	2,927,577.40	22,530,816.00	55,727,577.40
6/30/2034	32,132,344.00	70,840.97	23,917,656.00	56,120,840.97
Total	**62,401,528.00**	**93,040,801.46**	**46,448,472.00**	**201,890,801.46**

Note: (1) Assumes 4.55% interest cost on CARS on an actual/360 day count basis beginning on each series conversion date.

Summary

- County Retirement System will swing from 107% (7% overfunded) to less than 75% (25% underfunded) within 5 years unless System consistently outperforms 8% investment rate of return assumption
  - Annual contributions will increase by $113 million
- $429.6 million of projected $1.2 billion unfunded amount is due to negotiated enhancements of retirement benefits to match State of California's increases for State employees
- At peak, System had $316 million in excess earnings, less than the $429.6 million cost of the enhancements
- Had it not been for our 1995 issuance of $534 million in POBs, our System would never had been overfunded, greatly reducing the argument that enhancements could be provided "at no cost to the taxpayers"
- "Overfunding" of pension systems gives rise to labor demands for enhancement of benefits, even though the overfunding of the pension systems may be only temporary due to stock market swings
- There is an obvious advantage to an employer to avoid having its pension system become overfunded, including but not limited to through the use of POBs
- Prudent use of POBs to finance "unfunded liabilities" should be exercised
  - Pension Reforms Needed